No. 8606

In the United States Circuit Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN FRANCIS NEYLAN, RESPONDENT

ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE PETITIONER

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QUESTION PRESENTED

Where the taxpayer in 1931 sold at a loss shares of stock which had been held by him for more than two years, and within less than thirty days thereafter repurchased an identical number of shares of the same stock, and on the same day of such repurchase sold all of the shares, is the loss sustained by the taxpayer deductible as a capital net loss or as an ordinary loss?

STATUTES INVOLVED

The statutes involved herein will be found in the Appendix, *infra,* pp. 18–20.

STATEMENT

The facts, as developed by a stipulation between the parties (R. 25–29), may be stated briefly as follows:

On December 23, 1931, the taxpayer sold a number of shares of several different blocks of stock which he had owned for more than two years. The shares sold, the date of acquisition by the taxpayer, the cost to him, and the selling price, were as follows (R. 15):

Shares sold	Date acquired	Cost	Selling price
200 Atlas Diesel B	1/15/29	$8,804.80	$188.00
200 Interstate Equities, Preferred	9/23/29	9,600.00	1,957.00
500 Interstate Equities, Common	10/7/29	8,875.00	215.00
1,000 National Auto Fibre A	9/14/28	21,876.79	814.30
Totals		$49,156.59	$3,174.30

On December 24, 1931, the day following the sale of the above shares, the taxpayer purchased a like number of the same shares and later during that day sold the shares so purchased. The cost and selling price of those shares were as follows (R. 15):

Shares sold	Cost	Selling price
200 Atlas Diesel B	$228.00	$188.00
200 Interstate Equities, Preferred	2,085.00	1,957.00
500 Interstate Equities, Common	327.50	215.00
1,000 National Auto Fibre A	930.00	800.00
Totals	$3,570.50	$3,160.00

As a result of the several transactions outlined above, the taxpayer was actually out of pocket the net amount of $46,392.79. He claimed that amount as an ordinary loss in his income tax return for 1931, and it is expressly stipulated (R. 29) that if the loss claimed is allowable, there is no deficiency in his income tax for that year.

In his deficiency notice (R. 10), the Commissioner held that the loss on the first sale, that of December 23, 1931, was not allowable in accordance with Section 118 of the Revenue Act of 1928, and that the loss on the second sale, that of December 24, 1931, was a capital loss and not an ordinary loss.

The Board of Tax Appeals (R. 16) held that the loss sustained by the taxpayer in the amount of $46,392.79 was an ordinary loss and was so deductible in his income tax return.

SPECIFICATION OF ERRORS TO BE URGED

Stated briefly, the Commissioner urges that the Board erred in not holding that the loss of $46,392.79 sustained by the taxpayer during the year 1931 was a capital net loss and was deductible as such. The Commissioner's assignments of error, all of which are relied upon, are stated in full at pages 21, 22, and 23 of the Record.

SUMMARY OF ARGUMENT

The "wash sale" provision of the statute (Section 118 of the Revenue Act of 1928, *infra*), precluded the deduction of the loss sustained by the taxpayers upon the first sale of the stock, because it was followed by a repurchase within a period of thirty days. In such case, the statute provides that the basis of the new stock remains the same as the basis of the original stock. Section 113 (a)(11) of the Revenue Act of 1928, *infra*. Since, for the purpose of determining the base, the holding of the original stock and of the repurchased stock are treated as one, the two holdings should also be treated as one, and added together, for the purpose of determining the period for which the stock shall be deemed to have been held in applying the capital assets provision of the statute, Section 101 (c)(8) of the Revenue Act of 1928, *infra*. *Helvering* v. *N. Y. Trust Co.,* 292 U. S. 455. The tacking together of the two holdings for the purpose of the rate, as well as for the purpose of the base, is required for harmony and consistency. The intent

of the statute is clearly to treat the stock acquired on the repurchase as taking the place of the original stock, and that intent should be given effect for the purpose of fixing the rate as well as the base, although the statute does not make an express provision to that effect with reference to the rate. Neither the legislative history nor the executive interpretation are such as to compel this Court to adopt a contrary interpretation. When Congress did put in an express provision to apply to the fixing of the rate in the 1932 Act, it was clarifying and not changing the law.

ARGUMENT

Where the taxpayer in 1931 sold at a loss certain stock which had been held by him for more than two years, and within less than thirty days later repurchased the same number of shares of the same stock, which he sold on the same day, the loss is deductible as a capital net loss

In deciding this case, the Board followed its decision in the case of *Heinz* v. *Commissioner,* 34 B. T. A. 885, where it passed upon this question for the first time. The *Heinz* case is now pending on appeal in the Circuit Court of Appeals for the Third Circuit. The *Heinz* case was also followed by the Board in deciding the cases of *Cary* v. *Commissioner,* unpublished, decided August 18, 1936, affirmed *per curiam,* without opinion, by the Circuit Court of Appeals for the Second Circuit on June 28, 1937; *Peck* v. *Commissioner,* decided September 30, 1936, and affirmed by the Circuit Court of Ap-

peals for the Second Circuit on June 28, 1937; and *Lewis* v. *Commissioner,* 34 B. T. A. 996, pending on appeal in the Circuit Court of Appeals for the Second Circuit.

In the *Heinz* case, the question was fully discussed by the Board in a majority opinion, and the contrary view discussed in a dissenting opinion, while in the other cases, the Board's opinion consisted of a simple statement to the effect that it was following the *Heinz* case.

A similar question is also involved in *Augustus* v. *Moore,* not officially reported, but found in 1937 CCH, Vol. 4, ¶9400, in which the District Court for the Northern District of Ohio held in favor of the Government on June 12, 1937. In that case, the court said:

> The purpose of the "wash sale" provision of the Revenue Act was to invalidate deductions claimed for losses on securities repurchased within thirty days before or after their sale. The clear intendment of such action by the Congress compels, as it seems to me, the treating of the new stock acquired as taking the place of the original shares. There is nothing binding in the earlier interpretations of statutes by the Commissioner, and even if the Commissioner had otherwise interpreted the law, it would not foreclose judicial construction.
>
> In each of the stock transactions, it is clear that the obvious purpose was to transmute what would have been a capital loss

> into an ordinary loss by executing a sale, repurchase and resale, all within a thirty-day period. To put it plainly, the favorable change in deductible loss was attempted to be accomplished by the use of a "wash sale." The legislative purpose was to treat the stock repurchased as the stock originally held, where it was substantially identical (here, it was identical in character and number of shares). Such sale and repurchase, from a taxation standpoint, left the holdings as they originally stood. This being so, a capital loss resulted from the final sale occuring more than two years after the original purchase.

Because of the taxpayer's subsequent repurchase within a period of thirty days, his loss on the first sale was not deductible under the wash sale provision of the statute, Section 118 of the Revenue Act of 1928, *infra.* The statute further provides, in Section 113 (a) (11), *infra,* that the basis for the stock acquired in the repurchase shall be the same as the basis of the stock originally held, with a certain adjustment not here material. Because of these statutory provisions, the Commissioner here treated the shares sold on the second sale as if they had been held for more than two years, as in fact the original stock had been held, and treated the loss from their sale as a capital net loss.

The position of the Commissioner is that, since the statute provides that the basis for the stock acquired on the repurchase remains the same as the

basis of the original stock which had been disposed of in the wash sale, the stock acquired on the repurchase shall be treated as the stock originally held for the purpose, also, of determining the period for which it shall be deemed to have been held in applying the capital assets provision of the statute, Section 101 (c) (8), *infra*. If the holdings of the original stock and of the repurchased stock are treated as one for the purpose of fixing the basis, they should likewise be treated as one, and added together, for determining the period for which the stock has been held.

This consistent treatment of the new stock, as taking the place of the stock originally held, is required in order to give effect to the statute. Section 113 (a) (11), which in the case of shares bought after a wash sale substitutes the basis of the original shares for the basis of the new shares, is a definite indication of a statutory intent to treat the new shares as taking the place of the old shares. That intent should be given effect, we submit, not only for the purpose of fixing the base, but also for the purpose of determining the period of holding by the taxpayer, in applying Section 101 (c) (8). The two holdings are treated together for the purpose of fixing the base, and they should also be treated together for the purpose of fixing the rate. *Helvering* v. *N. Y. Trust Co.*, 292 U. S. 455. The same treatment for the two purposes is impelled, we submit, by all concepts of harmony and con-

sistency. We recognize that, as stated by the Board in its opinion in the *Heinz* case, 34 B. T. A. 885, 887, this treatment is not expressly required by a literal reading of the statute, but we submit that it is required to promote the intent of the statute and required by dictates of logic and harmony. As indicated by Section 113 (a) (11), the intent and meaning of the statute with regard to the whole subject matter of "wash sale" transactions and their consequences are clear. The statute clearly means that the original stock and the new stock are to be treated as the same, and that meaning, which is expressly stated with respect to the base, should be given effect also with respect to the rate. *Helvering* v. *N. Y. Trust Co., supra.*

In the *N. Y. Trust Co.* case, it was held that, since the donee must take the donor's base, he is entitled to tack his holding to that of his donor in order to determine the period of holding for the purpose of applying the capital assets provision of the statute. The Court said (p. 467): "* * * the continuity required to be used to get the base was also intended for use in finding the rate." In order to give effect to the intent of the statute, a continuity of holding should be found to have existed here, despite the intervening wash sale, just as in the *N. Y. Trust Co.* case it was found to exist despite a change in the legal identity of the holder.

The result of the decision of the Board, however, is to treat the two holdings together to arrive at the

base, but to separate them to arrive at the tax rate. The majority opinion of the Board in the *Heinz* case refused to follow the *N. Y. Trust Co.* case, making some attempt at distinguishing it and at pointing out its inapplicability to the present question (pp. 893–896). The Board there said (p. 895) that the change in the capital gain provision from the original enactment as Section 206 of the 1921 Act, where its application was limited only to gains, to the later Revenue Acts, where it was made applicable to both gains and losses (Sections 208 of the Revenue Acts of 1924 and 1926, and Section 101 (c) (8) of the Revenue Act of 1928), takes away much of the compelling force from the principle of conforming the rate to the base. We submit that that change does not diminish the soundness or force of the principle of conformity which was adopted both by this Court and by the Supreme Court in the *N. Y. Trust Co.* case. The Board also attempted (p. 896) to distinguish the *N. Y. Trust Co.* case on the ground that there "the same specific property" was held throughout, while in this situation the original property had been sold and new property had taken its place. We submit that that attempted distinction is wholly without merit, because of the intent of the statute to treat the new stock as taking the place of the old. As pointed out by the dissenting opinion in the *Heinz* case (p. 901), there is even more reason here for requiring conformity for both the purpose of the rate and

the base than there was in the *N. Y. Trust Co.* case, because here we are dealing at all times with the same taxpayer. The Board in the *Heinz* opinion, in rejecting the doctrine of the *N. Y. Trust Co.* case, also relied upon *McFeely* v. *Commissioner,* 296 U. S. 102. We submit that the decision in the *McFeely* case is not really opposed to our position in this case. Although there the Supreme Court did not follow the rule of conformity of treatment for the purpose of rate and base, it is clear that it did not do so in order to reach a more equitable result in that case, and that the Court did not in any way disturb the doctrine of conformity which it had established in the *N. Y. Trust Co.* case.

The Board in the majority opinion in the *Heinz* case (p. 889), in refusing to give effect to the intent of the statute, pointed out that the "base" provision in the first statutory enactment with reference to "wash sales", Section 202 (d) (3) of the Revenue Act of 1921 (which is a prototype of Section 113 (a) (11) of the 1928 Act), was limited "for the purposes of this section" to the base to be used, and that that limitation "negates" any broader implication which might be drawn from Congressional reports that the new property is to take the place of the original property. But the "base" provision in the 1928 Act, Section 113 (a) (11), is not so restricted by the words "for the purpose of this section" as was its prototype, and therefore the broader implication arising from the

other provisions of the statute is not "negated" in the 1928 Act, as the Board felt it to be in the 1921 Act.

In arriving at its conclusion upon this question, the majority opinion in the *Heinz* case relied (pp. 890–893) not only upon the legislative history of the capital gain provision of the statute, pointing out the change, which has already been mentioned, from the original enactment in 1921 to the later Acts so as to apply to both capital gains and capital losses, but also relied upon the prior administrative interpretation of the statute. After referring to G. C. M. 1210, IV–2 Cumulative Bulletin 60; I. T. 2443, VII–2 Cumulative Bulletin 127, and I. T. 2576, XI Cumulative Bulletin 164, the Board concluded that "the unvarying practice" of the Government had been to treat the property sold on the second sale as a sale of property different from the original property and to regard the capital loss provision as inapplicable. The Board pointed out in the *Heinz* case (p. 893) that that practice was continued until the latter part of 1934, when in I. T. 2832, XIII–2 Cumulative Bulletin 201, the position was taken, modifying the earlier I. T. 2443, that the period of holding for the purpose of the capital assets provisions of the 1928 and earlier Acts runs from the date of acquisition of the original securities.

We submit that there is nothing of any binding character in the interpretation of the statutory

provisions given by the Commissioner in the earlier rulings. See *Helvering* v. *N. Y. Trust Co., supra,* p. 468. The cautionary notice published in the bulletins in which those rulings appear clearly points out that they do not commit the Treasury Department to any interpretation of the law. The taxpayer could not acquire any vested right by virtue of the earlier Departmental interpretation of the law. An erroneous interpretation of the law by the Treasury Department does not estop the Government from asserting the tax, even though a taxpayer may have relied on it. *Manhattan General E. Co.* v. *Commissioner,* 76 F. (2d) 892 (C. C. A. 2d), affirmed, 297 U. S. 129.

Not only is the prior erroneous departmental interpretation of the statute not binding on the Government, but also the courts are in no sense obligated to follow it. It is well established that the courts are not obligated to follow blindly even regulations or treasury decisions (which are of greater force than any of the rulings in I. T.'s or G. C. M.'s), but will follow them only to the extent that they correctly state the legal effect of a statute. *Manhattan General E. Co.* v. *Commissioner, supra.*

When, from the decision in the *N. Y. Trust Co.* case, it became apparent that the courts had not agreed with the Treasury Department on the interpretation which it gave to the statute in the earlier rulings, the Department changed its position and, in I. T. 2832, adopted an interpretation

in keeping with the decision of the Supreme Court on the subject. This the Department clearly had a right to do, and was not estopped from doing it by reason of its former interpretation. Under the Revenue Acts, it is recognized that the Commissioner can change or modify his position or his regulations to comply with the correct interpretation of the law, either as construed by the courts or as determined by him from experience or necessity. Section 1108 of the Revenue Act of 1926, as amended by Section 605 of the Revenue Act of 1928, and Section 506 of the Revenue Act of 1934. The right of the Commissioner to change his position, and even to make his change retroactive in application, has been upheld. *Manhattan General E. Co.* v. *Commissioner, supra.*

In arriving at its decision on this question, the majority opinion of the Board in the *Heinz* case also relied (34 B. T. A. 885, 897–899) upon its conclusions that Congress recognized that under the existing law (the 1928 Act) the new shares did not take the place of the old shares for the purpose of determining the period of holding, and that by the addition of subparagraph (D) to Section 101 (c) (8) in the 1932 Act, Congress made a deliberate change in the law. We submit that both of these conclusions are wrong. It is true, as the majority opinion pointed out, that in the report of the House Committee (H. Rep. No. 708, 72d Cong., 1st Sess., p. 16) the existing law is interpreted as providing

that for the purpose of determining the period of holding the holding of the original shares and of the repurchase shares are not to be tacked, and that the loss upon the sale of the new shares is deductible as an ordinary loss. However, as pointed out in the dissenting opinion in the *Heinz* case (34 B. T. A. 885, 901), the Senate Finance Committee had a different view as to the interpretation of the 1928 Act and as to the effect of adding subparagraph (D) to the 1932 Act. S. Rep. No. 665, 72d Cong., 1st Sess., pp. 22–23. The Senate Committee apparently thought that the new provision in the 1932 Act would be merely declaratory of the existing law—would be merely a clarification and not a change in the law. This conflict of views between the House and the Senate Committees as to the interpretation of the prior law makes the legislative interpretation thereof of little value in determining the correct interpretation of the prior law.

Moreover, "the courts alone may in the end declare what a statute means." *American Exchange Securities Corp.* v. *Helvering,* 74 F. (2d) 213, 214 (C. C. A. 2d). The determination of the construction of the meaning of the statute is a judicial function. *Walker* v. *United States,* 83 F. (2d) 103, 106 (C. C. A. 8th). This function is so entirely and purely judicial that it is beyond the power either of the executive (*Manhattan General E. Co.* v. *Commissioner, supra; Louisville & N. R. Co.* v. *United States,* 282 U. S. 740, 757) or of Congress

(*Levindale Lead Co.* v. *Coleman,* 241 U. S. 432, 439) to control.

The addition of subparagraph (D) to Section 101 (c) (8) of the 1932 Act expressly put into the statute that which in effect was in the provisions of the prior law although not therein expressly stated, namely, that the property repurchased in connection with a wash sale takes the place of the original property for the purpose of the rate as well as the base. We submit that the addition of this express provision to the 1932 statute was not a change in the law as it theretofore existed, but simply a clarification of what may have been doubtful. *Helvering* v. *N. Y. Trust Co., supra,* p. 468.

It must be remembered that when Congress first enacted the wash sale provisions into law, in Section 214 (a) (5) of the 1921 Act, and reenacted it in the subsequent revenue acts, it did so for the obvious purpose of closing a gap and not for the purpose of opening a door to tax avoidance, such as is permitted by the decision of the Board below. By the employment of this device of the intermediate wash sale, the taxpayer is, nullifying the effect of the wash sale provision of the law, attempting to destroy the fact that his holding was one of capital assets, and he is attempting to escape the limitation on the deduction of his capital loss. He is attempting by this device of the intermediate wash sale to do indirectly what he could not do directly. See *Gregory* v. *Helvering,* 293 U. S. 465.

CONCLUSION

It is submitted that the decision of the Board is erroneous and contrary to the law, and should therefore be reversed.

Respectfully submitted.

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SEPTEMBER 1937.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 101. CAPITAL NET GAINS AND LOSSES.

* * * * *

(c) *Definitions.*—For the purposes of this title—

* * * * *

(2) "Capital loss" means deductible loss resulting from the sale or exchange of capital assets.

(3) "Capital deductions" means such deductions as are allowed by section 23 for the purpose of computing net income, and are properly allocable to or chargeable against capital assets sold or exchanged during the taxable year.

(4) "Ordinary deductions" means the deductions allowed by section 23 other than capital losses and capital deductions.

* * * * *

(8) "Capital assets" means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business. For the purposes of this definition—

(A) In determining the period for which the taxpayer has held property received on an exchange there shall be included the period for which he held the property ex-

changed, if under the provisions of section 113, the property received has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged.

(B) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under the provisions of section 113, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

(C) In determining the period for which the taxpayer has held stock or securities received upon a distribution where no gain is recognized to the distributee under the provisions of section 112 (g) of this title or under the provisions of section 203 (c) of the Revenue Act of 1924 or 1926, there shall be included the period for which he held the stock or securities in the distributing corporation prior to the receipt of the stock or securities upon such distribution.

* * * * *

SEC. 113. BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Property acquired after February 28, 1913.*—The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—

* * * * *

(11) WASH SALES OF STOCK.—If substantially identical property was acquired after December 31, 1920, in place of stock or securities which were sold or disposed of and in

respect of which loss was not allowed as a deduction under section 118 of this Act, or under section 214 (a) (5) or 234 (a) (4) of the Revenue Act of 1921, the Revenue Act of 1924, or the Revenue Act of 1926, the basis in the case of the property so acquired shall be the basis in the case of the stock or securities so sold or disposed of, except that if the repurchase price was in excess of the sale price such basis shall be increased in the amount of the difference, or if the repurchase price was less than the sale price such basis shall be decreased in the amount of the difference;

* * * * *

SEC. 118. LOSS ON SALE OF STOCK OR SECURITIES.

In the case of any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) or has entered into a contract or option to acquire substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition, no deduction for the loss shall be allowed under section 23 (e) (2) of this title; nor shall such deduction be allowed under section 23 (f) unless the claim is made by a corporation, a dealer in stocks or securities, and with respect to a transaction made in the ordinary course of its business. If such acquisition or the contract or option to acquire is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed.

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